Weekly Market Summary

18th of Dec 2015

Fed Raises Rates by 25 bps, Promises To Remain Extremely Accommodative

Fadi Nasser (SVP – Head of Treasury Sales)

The US Federal Open Market Committee (FOMC) met on Wednesday and decided to raise the o/n Fed funds rate range by 25 bps to ¼ -- ½ %.

Over the past year or so, the Fed has maneuvered itself into its present predicament. Its efforts at "forward guidance" and its use of models that may not be completely appropriate in this current economic environment have boxed the US central bank into a corner. Needless to say that Fed officials – like many economists – poorly projected how the financial world would look like today: No one saw economic growth remaining as mediocre as it has been; No one saw Chinese growth slowing down the way it has, coupled with a move to focus its economy more on consumption and less on investment; No one foresaw the European Union stalling the way it has; No one could imagine oil prices falling from around $110 a barrel to close to $36 a barrel; No one could have projected the fall in commodity prices to the levels they are now at; No one saw emerging market nations such as Venezuela, Brazil or Argentina facing their current deep problems; and surely No one expected the Russia/Ukraine conflict to escalate in 2014, or the unsettling situation in the Middle East to worsen and expand this year (with the possible worldwide terror threat arising out of this chaos).

Below is a summary of the major highlights / Wordings that was either slightly more upbeat/downbeat compared to our expectations

Major Highlights

- The Committee judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2 percent objective. Given the economic outlook, and recognizing the time it takes for policy actions to affect future economic outcomes, the Committee decided to raise the target range for the federal funds rate to 1/4 to 1/2 percent. The stance of monetary policy remains accommodative after this increase, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation.

- In determining the timing and size of future adjustments to the target range for the Federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2% inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

- The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction., and it anticipates doing so until normalization of the level of the Federal funds rate is well under way

Extremely Upbeat Assessment of the US Economy

- Household spending and business fixed investment have been increasing at solid rates in recent months
- Underutilization of labor resources has diminished appreciably since early this year
- The Committee judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2% objective

Downbeat Assessment

- Net exports have been soft
- Market-based measures of inflation compensation remain low; Some survey-based measures of longer-term inflation expectations have edged down.

The market reaction was limited, suggesting the policy and statement together were reasonably close to investor expectations. Post-meeting rates in the overnight indexed swap (OIS) market suggest investors expect the effective funds rate to settle at around 0.35% after liftoff (up from 0.15% in recent days). 2s, 5s and 10-year US Treasury yields remained confined in a 2-3 bps range following the Fed announcement, whilst stocks rallied big (Dow Jones, S&P and NASDAQ indices all closing roughly 1.5% up on the day). The USD initially rallied, lost ground and then rallied again into the close (it moved in a 1.0885 --- 1.1010 range against the Euro, and was last trading this morning at 1.0860).

Updated Fed Dot Plot (FOMC members' forecasted Federal funds rates at year-end as reported in the FOMC Economic Projections)

FOMC Meeting	2016 Year-End Median	2017 Year-End Median	2018 Year-end Median	Long Term
December 16th, 2015	1.375%	2.375%	3.25%	3.50%
September 17th, 2015	1.375%	2.625%	3.375%	3.50%
June 17th, 2015	1.625%	2.875%	--	3.75%
Current Market Pricing	0.86%	1.35%	1.65%	

Either Fed officials are totally off on their future rate projections or markets remain trapped in a big bond bubble!!!

Summary of Economic Projections (SEP)

Summary of Economic Projections

	2015	2016	2017	2018	Longer run
Real GDP growth*					
December	*2.1*	*2.4*	*2.2*	*2.0*	*2.0*
September	*2.1*	*2.3*	*2.2*	*2.0*	*2.0*
Unemployment*					
December	*5.0*	*4.7*	*4.7*	*4.7*	*4.9*
September	*5.0*	*4.8*	*4.8*	*4.8*	*4.9*
PCE inflation*					
December	*0.4*	*1.6*	*1.9*	*2.0*	*2.0*
September	*0.4*	*1.7*	*1.9*	*2.0*	*2.0*
Core PCE inflation*					
December	*1.3*	*1.6*	*1.9*	*2.0*	
September	*1.4*	*1.7*	*1.9*	*2.0*	
Fed Funds rate*					
December	*0.375*	*1.375*	*2.375*	*3.25*	*3.50*
September	*0.375*	*1.375*	*2.625*	*3.375*	*3.50*

* Data shown are medians or mid-points of median ranges.

Note: GDP growth and inflation forecasts are Q4/Q4. Unemployment is the Q4 average. The funds rate is the level at the end of the year.

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